Fox-Smith Wealth Management Quarterly Commentary

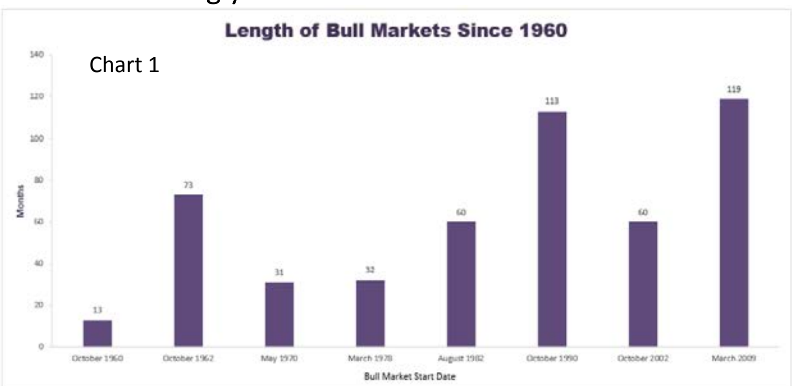
2nd Quarter - 2019

My Message to the FED, "Please Step More Carefully This Time!"

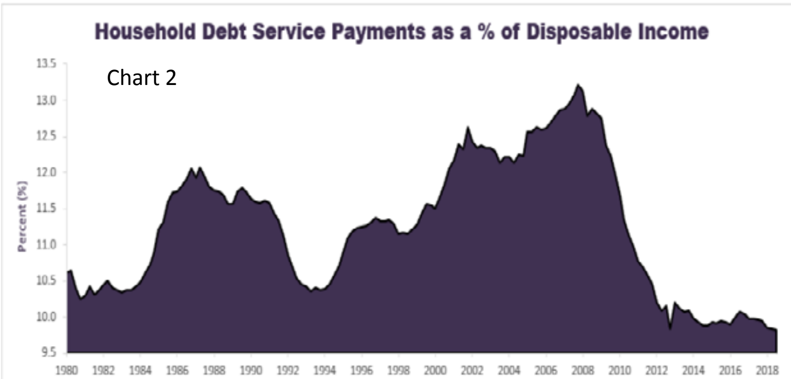
2019 2nd Quarter Economic Outlook and Market Commentary – Gustin D. Fox-Smith, AIF®, ChFC®

After one of the best performing quarters in my lifetime, it is clear that the FED was the culprit in the late 2018 correction. As I predicted in my year end commentary, the market has exploded in response to the FED ceasing their tightening action for two months. And even better news, the FED started selling treasuries again a few weeks ago and they appear to be taking a much more sustainable approach this time. They are selling at about half the pace of last year and if the market hasn't seen good financial data and rising prices, they do not sell that day. In my opinion, this is how it should have been handled all along. Now that the FED is behaving, my thoughts turn to trying to read other structural risks in the market to help protect our clients and seize opportunities when they arise.

Even though this market has now set the record as the longest ever without a 20% pullback in the S&P500, (see Chart 1) there are still plenty of reasons to remain positive about the coming year.



Source: Cetera Investment Management, JPMorgan, Standard & Poor's. Data as of 2/28/2019

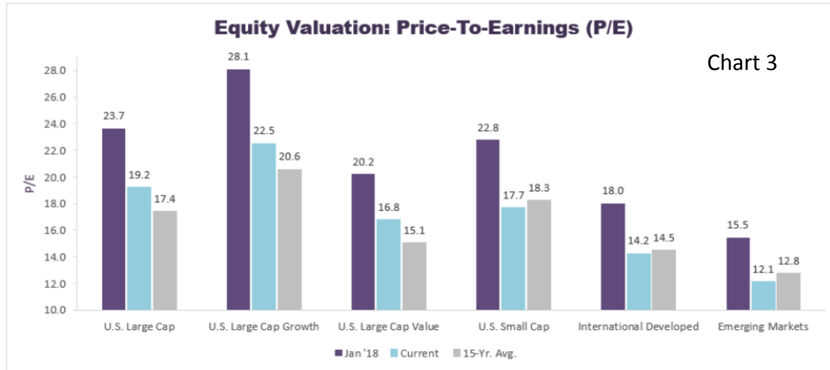


Source: Cetera Investment Management, Federal Reserve Bank of St. Louis. Data as of 9/30/2018.

- The rate of job creation remains very high, keeping unemployment at generational lows.
- Labor shortages are causing the fastest increase in wages we have seen in over 20 years.
- US Consumers, responsible for 2/3 of total economic activity, still have debt service payments at 40-year lows and growing net worth, a positive sign for continued spending. (see Chart 2)
- The leading economic indicators are all still positive, albeit not as positive as they were a year ago.
- Capital Goods orders and other corporate spending are near record highs.
- Trade war stress is beginning to decrease as the US and China are nearing an agreement.
- Stocks were stretching their valuations too high a year ago, but now with a correction and simultaneous earnings spike, stocks are right near their perceived fair values again, relieving some fear in the market. (see Chart 3)

So, where are the risks to this market? I believe they will not be felt until sometime in 2020, but they are mounting.

- The yield curve has inverted, but only briefly. This occurs when the rate on 2yr. treasuries is higher than the rate on 10 yr. treasuries and it signals that the bond market is pessimistic about the longer term. An inverted yield curve typically predicts recession within 12 months, but it remained inverted for only a few days – yet to be seen.
- US Consumers, responsible for 2/3 of total economic activity, still have debt service payments at 40-year lows and growing net worth, a positive sign for continued spending. (see Chart 2)
- Corporate debt vs. GDP is at record highs. This sounds scary at face value, but our corporations still have record cash reserves as well. We have simply been in a prolonged period where it has been cheaper to use the bank's money than to sell investments making more than the loan costs. The S&P 500 companies have enough cash to pay almost 80% of their debt with cash today if they chose to do so. That fact makes this indicator less of a concern.
- Annual GDP growth rates are trending lower. Yes, we are still growing, but slower and slower.



Source: Cetera Investment Management, Morningstar, Russell Investments, MSCI. US Large Cap Equities (Russell 1000), US Growth Equities (Russell 1000 Growth), US Value Equities (Russell 1000 Value), US Small Cap (Russell 2000), International Developed Equities (MSCI EAFE), and Emerging Markets (MSCI Emerging Markets). P/E is the Price-to-Earnings Ratio, based on trailing 12-months earnings. Data as of 2/28/2018.

In short, I see far more positives than negatives in today's market and I am always aware of the mantra "Cash is King". With record levels of cash in the system and 40- and 50-year lows in consumer debt service levels, any declines that come should be short lived and shallow. With that much cash, as soon as an attractive asset drops even a little, there is someone flush with capital to snap it up and stabilize the price.

However, all that free cash has another effect that can be very frightening. Monetary velocity is about 3x faster than it was in the period from 2000 – 2016. It means market events take place much more quickly and violently, which has the tendency to cause investors to react out of fear more often.
Think about the last 2 bear markets. In 2000, the tech correction began and took over 27 months to hit bottom and over 3 years to recover, almost 6 years total. The financial collapse began in late 2007 and took 18 months to bottom out in March 2009 and another 5 years to recover, 6.5 years total. In those long, drawn out corrections people can become complacent and it benefits them because many will not sell at the bottom and harm their long-term performance.

Financial Trivia

Last quarter's trivia question was "Who was the first billionaire in the U.S." and it was just our luck that the answer to this question remains in debate. For decades it was believed that J.D. Rockefeller was the first billionaire. However, several years ago his descendants made the claim that his net worth never actually reached that level during his life. Investigations are ongoing, but if he was not the first, then we know for certain that Henry Ford would claim the title of first Billionaire. Due to the controversy, we awarded a prize to the first person to give us each of their names and the proud owners of shiny new Starbucks gift cards were D. Bardwick and V. and M. Pearson
This quarter's question, again for a prize to the first person to send an e-mail with the correct answer *(Be honest, no "googling" it!)*

Which stock has the highest percentage gain from its IPO price in market history?

S&P500 Index, Trailing 12 months Source Yahoo Finance

In contrast, the last growth cycle brought us the Black Monday crash of 1987 which saw the market lose nearly 50% in just 3 days and recover completely within 4.5 months. Similarly, this recent event (See Chart 4) was a market swoon of roughly 20% that was over in just 6 months. Investors are much more likely to make incorrect fear-based decisions when they see the market losing 1000 points a day as it sets us up with a sense of panic and urgency. Be aware of this when the next correction comes and remember that what goes down fast usually comes back fast as well and just be patient.

<u>Who are the Fox-Smith Wealth Management Client Liaisons?</u>

Jenny Hobbs, Mike Worley, and Alex Liss make up the Client Liaison team and are here to serve! Since our client support team are all securities licensed and trained to provide a higher level of assistance, it didn't seem right to simply call them "Administrative Assistants". They really are more like the P.A. at your doctor's office who can handle most of the day-to-day requests from patients including writing prescriptions, etc. Because of this added capability, we felt the title Liaison was more fitting. Their purpose is to address client service needs so that you don't have to wait until an Advisor is able to follow up, allowing you to get what you need much more quickly.

Did you know your Liaison team can help you with all of the following?

- Address Changes
- RMD's
- Account Inquiries
- Tax Information
- Deposits, withdrawals and wire requests
- And so much more!

And, of course, should your inquiry require the attention of your Advisor, the Liaison team will ensure they follow up with you right away.

Did You Have a Surprisingly Large Tax Bill This Year?

When filing our taxes, many of us were surprised to have an unexpectedly large tax bill for 2018. We have had a lot of calls on this topic so I wanted to explain one of the contributing factors, Mutual Fund Capital Gains.

2018 brought some of the largest capital gain distributions ever. How do capital gains taxes work in your investments and why was your bill larger than expected? What actions did we take to help reduce taxes to some degree on your behalf? Read on for answers.

<u>What is a capital gains distribution</u>?

A capital gains distribution is a payment to shareholders that is prompted by a fund manager selling stocks or securities in a mutual fund. If the fund manager decides to sell a stock due to a changing outlook, or even if the fund must simply raise cash for shareholder redemptions and withdrawals, if the stock is trading higher than when the fund initially purchased it, the fund must distribute at least 95% of the realized gains to shareholders. Sadly, this means that often the largest gains are distributed in negative performance years since that is when investors choose to sell.

Capital gains distributions are taxed at capital gains rates to owners of mutual fund shares. The ugly part is that all shareholders receive the same distribution amount per share, regardless of how long they have owned the fund. This means that you could have purchased a fund in August last year and had a 15% loss by year end due to market conditions, yet you could still receive a taxable gain distribution from the fund. You lost money but paid a gain tax anyway, in essence you paid someone else's taxes. I prefer not to have to explain that after a tough market year, so we don't sit idly by and let it happen.

<u>What can be done to lower capital gains taxes?</u>

Two tax rules and some advance information can give us a way out. 1) In order to receive the capital gains distribution, you must own the fund on the day it is paid out. 2) IRS rules state that if you repurchase an investment within 30 days of sale, it is classified as a wash sale and will be treated as if you never sold it at all which brings the taxable distribution back into play. Fund groups declare estimates of their capital gains distributions in percentage terms in November or early December every year, which gives us some time to act and protect you.

As a rule, we watch for these estimates every year and for any funds that declare amounts larger than 5%-6% we have work to do. Let's assume we see a 10% estimate. We then identify every client that has not owned the fund long enough to have earned 10% (For example, if a fund last year paid out a 45% gain, it meant you had to own it for 3.5 years). If your investment is up more than 10% and we sell your shares, you would pay taxes on the full gain and it would cost you more. But if you haven't personally made 10%, we can sell the fund right before the gain is distributed and only pay on the actual gain you realized while avoiding the fund's gains distribution entirely.

But that creates a problem, we would be in cash at that point and we can't reinvest for 30 days and the market might take off without us. This was especially true last year with the whipsaw up and down in December. One strategy we use in client accounts is purchase a similar traded fund that invests in a comparable asset class as the original investment and hold it for 31 days and then sell and repurchase the original fund. This way, if the market does take off, we will get most of what we might have earned and still can avoid the wash sale rule. In the case of the 45% gains payer, we would have bought a dividend ETF that went up roughly 2.5% while we waited and then moved back to the original fund.

Add to this the tax loss harvesting strategies we employed in our taxable sector rotation accounts and, our goal was to deliver tax reductions nearly equal to the management fees you paid for the full year last year. This is why many with taxable accounts saw so much activity in December, we were cutting your tax bill if we could. There is simply no reason to pay any more in taxes than you must and we are here to help.

Webcasts

We made a valiant effort to deliver monthly economic web casts and did come through in all 3 months of the first quarter. Unfortunately, the legal wrangling and ad review hoops we had to navigate required many hours just to get approval to use our handful of slides each month. Sadly, it is clear we cannot afford the time to gain approval for a webcast every month.

However, the feedback from those who have attended has been very positive so we do not want to retire the webcasts completely. In order to deliver a quality webcast that has been through the compliance gauntlet, we will now offer the webcasts quarterly in the first month of each quarter. Please see the dates listed below for the updated schedule.

Dates of Upcoming Webcasts:

(2:00pm MT/1:00pm PT/3:00pm CT/ 4:00pm ET)

May 14th, 2019
July 30th, 2019
October 29th, 2019

We have been asked to include a brief financial education topic along with the current market update information each quarter, so that will be added as well. If you have specific ideas of topics you would like to know more about, please e-mail us and we will be sure to add the topic to the menu.

To participate, just send an email to Erin erin@fswealth.biz and a link will be sent to you so you can join the discussion.